From: Avi Tiomkin <ATiomkin@atglobalcap.com>
To: ehbarak <ehbarak1@gmail.com>
CC: nili Priell <nilipr@013net.net>
Date: Thu, 4/18/2013 4:55:35 PM
Subject: FW: Central bankers say they are flying blind

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Central bankers say they are flying blind

By Chris Giles in Washington

Growing concern at the International Monetary Fund over the long-term side-effects of interest rates close to zero came as some of the leading figures in central banking conceded they were flying blind when steering their economies.

Lorenzo Bini Smaghi, the former member of the European Central Bank's executive board, captured the mood at the IMF's spring meeting, saying: "We don't fully understand what is happening in advanced economies."

In this environment of uncertainty about the way economies work and how to influence recoveries with policy, Sir Mervyn King, the outgoing governor of the Bank of England, said that "there is the risk of appearing to promise too much or allowing too much to be expected of us".

It is troubling for monetary policy experts that their crisis-fighting tools – rates stuck at zero, money printing operations to bring down longer-term interest rates and encourage private sector spending, and efforts to calm financial market fears – might have nasty side-effects.

The central bankers were clear that they had got it wrong before the crisis, allowing themselves to be lulled, by stable inflation, into thinking they had eliminated financial vulnerabilities.

Speaking to the IMF's conference on rethinking global macro-economies, Janet Yellen, vice-chairman of the Federal Reserve, said: "In the years before the crisis, financial stability became a 'junior partner' in the monetary policy process, in contrast with its traditionally larger role."

The question now was whether central bankers are making the same mistake in their efforts to secure a recovery. Might they be storing up financial distortions that will bite in the future?

The IMF was clear in its global financial stability report that it did not want to see an end to the extraordinarily loose monetary policy being implemented across rich countries.

José Viñals, its head of financial stability, said central banks' efforts were "absolutely necessary". But the fund urged countries to use the breathing space offered to repair financial systems and also to address the unintended consequences.

It cited three new risks that were all potentially associated with easy money. In the US it sees lax underwriting standards on corporate borrowing at a level normally associated with a late stage in a boom-bust credit cycle.

It also sees easy money policies spilling over to emerging economies, particularly in the form of

foreign currency borrowing by emerging market corporates, leaving those companies vulnerable to foreign currency risks and emerging markets sensitive to hot money international capital flows.

Third, it worries that the exit from monetary easing could lead to a surge in market interest rates that could destabilise credit markets and the US economy.

“Put simply, we are in uncharted territory,” said Mr Viñals.

Central bankers are divided on the relevance of such concerns. While Mr Bini Smaghi said central bankers had become cornered into ever more exotic monetary experimentation, Ms Yellen sought to reassure her audience that the Fed was getting the balance right.

“I don’t see pervasive evidence of rapid credit growth, a marked build-up in leverage, or significant asset bubbles that would threaten financial stability. But there are signs that some parties are reaching for yield, and the Federal Reserve continues to carefully monitor this situation,” she said.

The problem outlined by Sir Mervyn was that the uncertainty is so pervasive that no one can be sure that the expansionary monetary policy is appropriate in a world where nations are learning they are poorer than they expected, but are not sure by how much. How can we be sure “we really are [not] running the risk of reigniting the problems that led to the financial crisis in the first place?” Charlie Bean, deputy BoE governor, asked the IMF panel.

His question underpinned the fear that the abilities of economies have been so damaged that expansionary policy is likely to go on for too long as central banks and governments seek to recover lost ground. Central bankers were not worried that monetary policy had already gone too far, but they were nervous the exit from easy money would prove too troublesome

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